

Revenue Review

Tennessee Department of Revenue

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REVENUE ...
Working For You



October 2006

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Did You Know...

You can receive notices and other publications instantly by signing up on one of the department's ListSers? Visit our Web site to subscribe to Revenue-News or lists dedicated to county clerks and city officials.

Contact Us:

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(615) 253-0600
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(800) 342-1003

Updates from Newly Created Taxpayer and Vehicle Services Division

Revenue's Taxpayer Services Division was renamed **Taxpayer and Vehicle Services** on July 1, 2006, to incorporate vehicle services functions previously handled in the Department of Safety's Title & Registration Division. The newly formed division includes 270 employees. Linda Kelley leads the division.

Vehicle services responsibilities include working with Tennessee's 95 county clerks to handle the issuance of registrations and titles for passenger and commercial vehicles, issuing more than 200 types of vehicle license plates, as well as distributing disabled parking placards and temporary permits. The division's motor carrier section serves as a one-stop shop for commercial vehicles, providing base-state vehicle registration and titling and international fuel tax reporting.

Debra Burke Joins Revenue's New Taxpayer and Vehicle Services Division



Debra Burke, formerly a manager in the Department of Safety's Title & Registration Division, has accepted the position of assistant director of Vehicle Services. Debra worked in the Title & Registration Division for 29 years and most recently held a position with Finance & Administration working on the TRUST project (Title &

Registration User System of Tennessee).

"Debra is excited at the opportunity to rejoin co-workers and will be a tremendous help as we work to enhance our operations in Vehicle Services," said Linda Kelley, director of Taxpayer and Vehicle Services. "Her knowledge of T&R operations, as well as her involvement with the TRUST project, will be invaluable as we blend Title & Registration functions with Taxpayer Services."

Revenue Adds New Credit-Card Option For Bill Payments

The Tennessee Department of Revenue now accepts credit cards for bill payments in addition to payment of the professional privilege tax. Professional privilege was the first tax type that customers could pay via credit card to the Department of Revenue through its Web site, www.Tennessee.gov/revenue. The department accepts the following credit cards: MasterCard, American Express and Discover Card. There is an associated 2.49% processing fee. The department is working to add this convenient payment option to other online tax filing applications.

"The Department of Revenue is committed to offering convenient, time-saving services to taxpayers to encourage voluntary compliance with our state's tax laws," said Revenue Commissioner Loren L. Chumley. "Credit-card payment options are one of Revenue's many online services."

Gift Tax Exemption Changes

Tenn. Code Ann. Section 67-8-104(c) provides that the standard exemption amount allowed for gifts to Class A donees is to be increased each year by the same amount, if any, that the annual exclusion amount for federal gift taxation purposes increases. Since the federal exemption was increased for gifts made in 2006 (IRC 5046), Tennessee's annual exemption is \$12,000 (per donee) for Class A gifts of a present interest made in 2006. The exclusion remains at \$11,000 for Class A gifts made for calendar years 2002 through 2005.



You may owe gift tax if you:

- Quitclaim property to someone, such as a child
- Transfer property to someone for less than the fair market value

Questions? Need more information? Call (615) 532-6438.

Tax Fraud Investigations Continue to Net Results

TDR is serious about tax fraud. Over the past few months, several news releases were issued related to fraud investigations handled by our Special Investigations Unit, including the following:

TDR special agents conducted the investigation that led to the arrest of Tommy James Hudgins on sales tax evasion charges on July 28. Hudgins, 34, is the owner of Affordable Tires, a retail tire store located at 5008 Highway 58 in Chattanooga, Tenn. Hudgins was indicted by the Hamilton County Grand Jury on July 20, 2006, on 14 counts of sales tax fraud.

On June 19, the Putnam County Sheriff's Office arrested Erich Wilhelm Reiser on sales tax evasion charges at his place of business. Reiser, 42, owns Cosmopolitan Grill, located at 931 Shipley Rd. in Cookeville, Tenn. Reiser was indicted by the Putnam County Grand Jury on June 12, 2006. The indictment charged that Reiser unlawfully and knowingly evaded the sales tax due the state of Tennessee by failing to file sales tax returns for Cosmopolitan Grill, Inc.

TDR agents conducted the investigation that led to the June 16th 12-year sentence of Glen Irven McCarthy, president of Gourmet Pizza Plus, Inc., Hendersonville, Tenn., for evasion of sales tax.

On May 17, TDR special agents arrested Charles William Jackson on sales tax evasion charges. Jackson, 57, owns CJ's Bar & Grill located at 4532 Knoxville Highway in Oliver Springs, Tenn. Jackson was indicted by the Morgan County Grand Jury on May 15, 2006, on one count of sales tax fraud, a Class E Felony in violation of Tenn. Code Ann. Section 67-1-1440(g).

Anthony Wayne (Tony) Love, owner of Microdata Services in Murfreesboro, was arrested April 12 at his Murfreesboro residence by agents of the Tennessee Department of Revenue on charges of state sales tax evasion. Love was indicted by the Rutherford County Grand Jury on 45 counts of sales tax fraud in violation of Tenn. Code Ann. Section 67-1-1440.

Cynthia Marie Martin, previous owner of The Beer Box in Clarksville, was arrested March 13 at her Clarksville residence by agents of the Tennessee Department of Revenue and the Montgomery County Sheriff's Office on charges of state sales tax evasion. Martin was indicted by the Montgomery County Grand Jury on 34 counts of sales tax fraud in violation of Tenn. Code Ann. Section 67-1-1440.

If You Suspect Fraud:

Call Revenue's toll-free tax fraud hot line (800) FRAUDTX, (800) 372-8389. You can report suspected tax fraud **anonymously**; you do not have to give your name, phone number or any other identifying information. To learn more about tax fraud, visit the department's Web site at www.Tennessee.gov/revenue.

Manufacturers Exemptions Under Tennessee Sales and Use Tax Laws

Tennessee law provides substantial sales tax benefits for businesses that qualify as manufacturers. A manufacturer is defined as a business whose principal activity (more than 50%) at a specific location is fabricating and processing tangible personal property for resale and consumption off the premises. The sales tax benefits may include the ability to purchase or repair qualified industrial machinery without payment of tax and the ability to purchase energy fuels and water at either a reduced rate or completely exempt from tax.

To qualify for the available sales tax benefits, a manufacturer must complete an "Application for Industrial Machinery Authorization" which is available on the department's Web site. The application asks specific questions about the taxpayer's operation and is required to be signed under penalty of perjury. The department grants the application based on representations made by the taxpayer on the application. If the representations on the application are incorrect, or if the taxpayer's business changes so that the application no longer accurately reflects the current operation, the taxpayer may be liable for taxes, penalties and interests on items purchased with the exemption.

Problems with a taxpayer's industrial machinery authorization are generally found when the taxpayer undergoes an audit. When the problem is found on audit, the taxpayer's liability for taxes, interest and possible penalties is for the period that is open under the statute of limitations, which is generally around three years plus the current year.

The following are common problems that are found when auditing a taxpayer that has an industrial machinery authorization:

1. Taxpayers use the industrial machinery authorization to purchase items that do not qualify as industrial machinery.

Industrial machinery is machinery, equipment and appurtenances necessary to, and primarily for, fabricating or processing tangible personal property for consumption off the premises. See Tenn. Code Ann. Section 67-6-102(a)(19) for the full definition of industrial machinery. Office supplies, copy machines and computers used in office operations do not qualify. Computers must actually be used in the manufacturing process more than 50% of the time in order to qualify. For items that are in question, the auditor will look at what the item is, how the item is used in the process, and how often it is used in the process. Because this is an exemption, the taxpayer bears the burden of demonstrating that the equipment at issue meets the definition of industrial machinery.

2. Taxpayers are not "primarily" in the business of manufacturing.

To determine if a taxpayer is "primarily" engaged in manufacturing as required by the law, the auditor will conduct a "51% test." Under this test, a majority of the sales at a location must consist of product which has been fabricated or processed at that location. If a taxpayer made \$5 million in gross sales at a location in Morristown, Tenn., which consisted of \$2 million in goods manufactured at that location and \$3 million in goods manufactured elsewhere, the taxpayer would not qualify as a manufacturer because it is not "primarily" engaged in manufacturing. Taxpayers that hold an industrial machinery

exemption and sell items manufactured elsewhere should periodically evaluate to ensure that they meet the "51% test."

3. Taxpayers perform services rather than manufacturing tangible personal property for resale.

In order to qualify as a manufacturer, the taxpayer must be fabricating or processing tangible personal property for resale. If a taxpayer is in the business of selling a service, it will not qualify as a manufacturer. The department has had a number of situations where the taxpayer is in the business of repairing or refurbishing goods such as tanks or telephones, and has had to revoke the taxpayer's industrial machinery exemption. Recently, the Tennessee Court of Appeals upheld the department's position that a seller of telecommunications services did not qualify as a manufacturer under Tennessee law because it is in the business of selling services and not tangible personal property. *AT&T Corporation v. Chumley* 190 S.W.3d 652 (Tenn. Ct. App. 2005).

4. Taxpayers are actually contractors rather than manufacturers.

Contractors often fabricate materials that they have contracted to install as an improvement to realty. Under Tennessee law, the contractor is not deemed to be selling tangible personal property under these facts, but instead is a user and consumer of those materials, and is required to pay tax on the materials. See October 2004 *Revenue Review* for a discussion of Contractor's Use Tax. The contractor will not qualify as a manufacturer because it is not fabricating or processing tangible personal property for resale.

Questions regarding qualification as a manufacturer are very fact specific. If you have additional questions, please contact the Department of Revenue or visit our Web site for more information.

Frequently Asked Franchise/Excise Tax Questions

Q: What change did Public Chapter 1019 (2006) have on the Venture Capital Fund exemption in Tenn. Code Ann. Section 67-4-2008(a)(5)?

Public Chapter 1019 provides that the capital of the fund can also include investments by one or more affiliates, if such affiliates also qualify as venture capital funds under this exemption. This change is effective for all tax years beginning on or after Jan. 1, 2006. Otherwise, there was no change to the original definition other than this clarification.

Q: Public Chapter 1019 (2006) allows the Industrial Machinery Credit (IMC) to be applied to both franchise and excise tax. Previously, the IMC applied only to the excise tax. Since my corporation has had losses and has not incurred any excise tax on which to apply IMC in prior tax years, will my IMC carryovers be able to offset franchise tax on my 2006 return?

Yes. For any tax year beginning on or after Jan. 1, 2006, all IMC available to be applied on that return, whether originating in that tax year or by a carryover from any prior tax year, will be used to offset both the franchise and excise tax. The 50% limitation will still apply, but it will be based on the total tax liability of both the franchise and excise tax.

Q: Two individuals are the members of LLC1, a limited liability company. LLC1 and an unrelated entity are the members of LLC2, a limited liability company. LLC1 and LLC2 are treated as partnerships for federal income tax purposes and for Tennessee franchise and excise tax purposes. LLC1 has a net operating loss (NOL) carryover from prior years. LLC2 has a credit carryover from prior years.

Pursuant to a plan of restructuring, the following steps take place simultaneously: (1) LLC1 purchases the membership interest of the other member of LLC2; (2) the members of LLC1 form Newco, a corporation, and contribute all of their membership interests in LLC1 to Newco in exchange for Newco stock. As a result, two individuals own the stock of Newco; Newco is the single member of LLC1; and LLC1 is the single member of LLC2. LLC1 and LLC2 will be treated as disregarded entities for federal income tax purposes and for Tennessee franchise and excise tax purposes.

What is the impact of this transaction on LLC1's NOL carryover and LLC2's credit carryover?

1. LLC1's NOL carryover will survive the restructuring transaction and will transfer to Newco. Before the restructuring, LLC1 was treated as a partnership. After the restructuring, LLC1 becomes a disregarded entity and is treated as a division of Newco. For franchise and excise tax purposes, this change is tantamount to LLC1 having undergone a merger, consolidation or like transaction. Normally, no NOL carryover is allowed in the case of a merger, consolidation or like transaction. However, Tenn. Code Ann. Section 67-4-2006(c)(3) provides an exception to this rule. When a taxpayer merges out of existence and into a shell entity that has no income, expenses, assets, liabilities, equity or net worth, the NOL carryover of the predecessor taxpayer (here, LLC1) survives and becomes available to the successor taxpayer (here, Newco). Newco was a shell entity when LLC1 became a disregarded entity that is treated as a division of Newco. LLC1's NOL carryover therefore survives and becomes the NOL of Newco.

2. LLC2's credit carryover will not survive the restructuring transaction. Before the restructuring, LLC2 was treated as a partnership. After the restructuring, LLC2 becomes a disregarded entity and is treated as a division of Newco (LLC2 is not treated as a division of LLC1, because LLC1 is disregarded and is itself treated as a division of Newco). For franchise and excise tax purposes, this change is tantamount to LLC2 having undergone a merger, consolidation or like transaction. No credit carryover is allowed in the case of a merger, consolidation or like transaction. Tenn. Code Ann. Section 67-4-2009(7)(B) provides an exception to this rule when a taxpayer merges out of existence and into a shell entity that has no income, expenses, assets, liabilities, equity or net worth. However, Newco is no longer a shell entity because it possesses the assets, liabilities and net worth of LLC1. LLC2's credit carryover therefore does not survive.

Are you a registered taxpayer? If YES, we need your tax contact's e-mail address, so we can e-mail information in the future. Call toll-free (800) 342-1003; Nashville-area and out-of-state callers, dial (615) 253-0600.

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www.Tennessee.gov/revenue

State's First Sales Tax Holiday a Success for Retailers and Shoppers



While the August collection data wasn't available at the time this newsletter went to press, initial feedback shows Tennessee's first sales tax holiday was greeted with much enthusiasm as area shoppers swamped local malls and stores to purchase school supplies, clothing and computers

that were tax-free during the holiday.

Mark your calendars now: The state will have another sales tax holiday from April 27-29, 2007. Unlike the August holiday, the April holiday will be a one-time sales tax holiday. The same items that qualified for the August holiday will also qualify for the April 2007 holiday.

Speakers Bureau

The Department of Revenue operates a speakers bureau. Professionals from across the state are available at no charge for professional groups, civic clubs, special events and academic organizations in Tennessee. Speakers are available to present on a variety of topics, from sales and use tax and franchise and excise taxes to inheritance and gift taxes.

Call (615) 532-4975, e-mail dayna.patzner@state.tn.us, or write to Dayna Patzner, Tennessee Department of Revenue, 500 Deaderick St., Third Floor, Nashville, TN 37242, to request a speaker. Requesting agencies/organizations should contact the department at least two weeks in advance and provide the following information:

- Date and time speaker needed
- Name of group requesting speaker
- Location
- Topic
- Desired length of presentation
- Number of people expected to attend presentation
- Contact name, address, phone number and e-mail address

We Want Your Feedback

Your feedback on our customer service and our Web site helps us provide outstanding service and meaningful, useful information on the Internet. To let us know how we're doing and how we can better meet your needs, visit our Web site, www.Tennessee.gov/revenue, and click on "Send us your feedback!" Separate surveys related to our service and our Web site are available for online completion.

Save the Date: Upcoming Seminars and New Business Workshops (NBW) Across the State

October

- Oct. 5** – 2006 Business Tax Update, Tennessee Chamber of Commerce & Industry, Millennium Maxwell House Hotel, Nashville
- Oct. 18** – 2006 Business Tax Seminar (Association of Government Accountants), Bartlett Performing Arts and Conference Center, Bartlett, 8 a.m. – 5 p.m.
- Oct. 25** – 2006 Business Tax Seminar (Association of Government Accountants), Willis Conference Center, Nashville, 8 a.m. – 5 p.m.

November

- Nov. 2** – Tennessee Business Tax, University of Tennessee at Chattanooga, Raccoon Mountain Room, 8 a.m. – 5 p.m.
- Nov. 8** – NBW, Chattanooga, 8:30 a.m. – 1:15 p.m.
- Nov. 9** – NBW, Johnson City, 8:30 a.m. – 11:45 a.m.
- Nov. 9** – NBW, Memphis, 9 a.m. – Noon
- Nov. 15** – NBW, Knoxville, 8:30 a.m. – 12:30 p.m.
- Nov. 28** – NBW, Nashville, 9 a.m. – 12:45 p.m.

Contact Us

- Taxpayer Services hot line: Statewide toll-free (800) 342-1003; Nashville-area and out-of-state callers should call (615) 253-0600.
- Vehicle Services hot line: Statewide toll-free (888) 871-3171; Nashville-area and out-of-state callers should call (615) 741-3101.
- Online tax help by e-mailing TN.Revenue@state.tn.us.
- Online vehicle help is available by e-mail at Email.T&R@state.tn.us.
- Streamlined Sales Tax hot line: In Tennessee, call (877) 250-2299. In Nashville and outside Tennessee, call (615) 253-0752.
- Streamlined Sales Tax online assistance by e-mailing Streamlined.Salestax.QandA@state.tn.us.
- Tax practitioner hot line: Statewide toll-free (800) 387-8395; Nashville-area and out-of-state callers should call (615) 253-0700.
- Local government hot line: (866) 562-2549.
- E-mail updates: Visit our Web site, www.Tennessee.gov/revenue, to subscribe to Revenue-News or lists dedicated to county clerks and city officials.
- Electronic commerce hot line: Statewide toll-free: (866) 368-6374. Nashville-area and out-of-state callers should dial (615) 253-0704.
- Speakers bureau: (615) 532-4975.
- Tax fraud hot line: To report tax fraud, call (800) FRAUDTX (372-8389).

Online Sales Tax Filing Statistics

Month	Number of Returns	Total of Amount Collected
May 2006	20,253	\$204,968,621
June 2006	20,466	\$195,281,564
July 2006	21,964	\$210,702,949



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